ETHICS IN RESPONSIBLE INVESTMENT: HOW TO INCORPORATE ETHICS INTO INVESTMENT ANALYSIS

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Abstract. This paper examines ethics in finance, specifically related to responsible investment. In recent years, socially responsible principles are becoming the *de facto* standard not only for socially responsible but also for profitable investing. For instance, the United Nations developed the Principles for Responsible Investment (PRI) in 2006, which require institutional investors to incorporate ESG (Environmental, Social and Governance) issues into investment analysis and decision-making processes. This raises the following question: can responsible investments be justified from an ethical point of view? In this paper I first explain responsible investments. Then, I turn to the ethical foundation of responsible investments. There are two arguments for responsible investments. I argue that both fail. Therefore, my conclusion is that the ethical foundation of responsible investments is not firm.

Keywords: Ethics in Finance, PRI, Responsible Investments, Evil-Company Principle, Conscientiousness.

1. INTRODUCTION

This paper examines ethics in finance, specifically related to investors. In recent years, socially responsible principles are becoming the *de facto* standard not only for socially responsible investing (SRI) but also for profitable investing. This phenomenon raises the following question: can responsible investments be justified from an ethical point of view? In this paper, I first explain responsible investments. Then, I turn to the justification problem. There are two arguments for responsible investments and I argue that both fail. Therefore, my conclusion will be that the ethical foundation of responsible investment is not firm.

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2. RESPONSIBLE INVESTMENTS

What are responsible investments? I will give two examples: Principles for Responsible Investment (PRI) and Code for Responsible Investing in South Africa (CRISA). Afterwards, I will explain their relation with the issue of 'ethical' investments.

2.1. THE PRINCIPLES

In 2006, the then UN Secretary-General Kofi Annan proposed the Principles for Responsible Investment (PRI). The principles require institutional investors to incorporate ESG (Environmental, Social and Corporate governance) issues into investment analysis and decision-making processes.

PRI[1]
Where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

Over 1900 investment institutions signatories comprising of asset owners, investment managers and service providers (May 7, 2018) signed on to these six principles for responsible investment[2]. In 2015, Japan's Government Pension Investment Fund (GPIF), the world's largest pension fund of approximately 137.5 trillion yen, joined the PRI.

What are ESG issues? Environmental issues include climate change, deforestation, and water risks. Social issues cover human rights, working conditions and modern slavery. Governance issues involve tax avoidance, executive pay and corruption. Thus, investors who are PRI signatories will assess how companies are managing their water risks in agricultural supply chains.

[1] Principles for Responsible Investment: https://www.unpri.org/about (accessed May 7, 2018).
[2] Signatories to the Principles for Responsible Investment: http://www.unpri.org/signatories/signatories/ (accessed May 7, 2018).

Another example of Responsible Investment is the Code for Responsible Investing in South Africa (CRISA), released in 2010:

CRISA[3]

1. An institutional investor should incorporate sustainability considerations, including environmental, social, and governance, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries.
2. An institutional investor should demonstrate its acceptance of ownership responsibilities in its investment arrangements and investment activities.
3. Where appropriate, institutional investors should consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors.
4. An institutional investor should recognise the circumstances and relationships that hold a potential for conflicts of interest and should proactively manage these when they occur.
5. Institutional investors should be transparent about the content of their policies, how the policies are implemented, and how CRISA is applied to enable stakeholders to make informed assessments.

The principles also require institutional investors to incorporate ESG issues into investment analysis and investment activities.

2.2. 'ETHICAL' INVESTMENTS?

The presence of responsible investments raises the following issues. (1) Do responsible investments pay? (2) Are they compatible with the fiduciary duties of trustees? (3) How should we measure ESG factors? (4) Which factor is the most important? (5) What is the relation between responsible investments and ethical investments?

When it comes to the last question, Russell Sparkes, a fund manager in the UK, explains that SRI was known as 'Ethical Investing' in the UK, but was replaced with 'Socially Responsible Investing (SRI)' for two reasons: "[I]n the Anglo-Saxon tradition, "ethics" is generally seen as something individual, about personal values', so 'it makes less sense to describe a pension fund: there is "an apparent contradiction of using the word 'ethical' to describe profit-maximising"[4]. This might be also why they use the word 'ESG issues' rather than 'ethical' issues in responsible investments.

[3] ICGN (The International Corporate Governance Network): https://www.icgn.org/sites/default/files/South%20African_Code.pdf (accessed May 15, 2016).

[4] Russell Sparkes, *Socially Responsible Investment: A Global Revolution (*New Jersey: John Wiley & Sons, 2002), pp. 357-367.

One might ask whether ESG issues are relevant to ethics. Aiko Kozaki and Masato Takebayashi from the Japan Research Institute conducted a comparative analysis of KPIs for ESG and ISO26000, showing that labor practices, environmental issues, fair operating practices, and consumer issues are ESG factors, but that human rights and community involvement and development are not[5]. Their analysis, however, raises only the current issue of KPIs for ESG; it does not show that ESG issues are irrelevant to ethics.

Thus far, I have analyzed responsible investments. Let us now consider the ethical foundation in responsible investments.

3. THE ETHICAL FOUNDATION

Can responsible investments be justified from an ethical point of view? In this section, I present two arguments for responsible investments. One is an argument from consistency: consistency requires that if you believe that companies are engaged in wrongdoing, then you must not invest in those companies. The other is an argument from the ‘evil-company principle’: it is wrong to invest in companies that are engaged in wrongdoing, whether you believe it or not. I argue that both arguments fail.

3.1. CONSISTENCY

The most common argument for responsible investments is the appeal to consistency. For instance, Amy Domini, an American investment adviser, makes this appeal:

> “There are two basic reasons for integrating social or ethical criteria into the investment decision-making process: the desire to align investments with values and the desire to play a role in creating positive social change. Consistency is almost always the motivation that causes investors to start down the path of becoming socially responsible in their investments”[6].

Richard T. DeGeorge argues that “[c]onsistency requires that if one believes that making and selling cigarettes is unethical, then one is ethically required not to own stock in such a company”[7]. We can present this appeal to consistency as an argument: consistency requires that if you believe that companies are engaged in wrongdoing, then you must not invest the companies; you believe that a certain

[5] Aiko Kozaki and Masato Takebayashi, “Domestic and International Situation and Analysis on ESG Investments”, *Securities Analysts Journal*, 49(5): 8-18, 2011, p. 14.

[6] Amy Domini, *Socially Responsible Investing: Making a Difference and Making Money* (Fort Lauderdale: Kaplan Publishing, 2001), p.13.

[7] Richard T. DeGeorge, *Business Ethics* (London: Pearson, 2013), p. 271.

company is engaged in wrongdoing; therefore, you are justified not to invest the company.

There are two examples of the inconsistent investor[8]. The first is teetotalism. It might be considered inconsistent for someone who practices and advocates teetotalism to hold shares in a brewery. The second is the British Medical Association: it was subjected to criticism because, while it had an anti-smoking policy, it held shares in companies that had substantial tobacco interests.

Joakim Sandberg, however, objects to this argument[9]. What is inconsistency? He sees at least five interpretations of inconsistency: logical inconsistency, arbitrariness, practical inconsistency, some error of instrumental rationality, and hypocrisy of pretense[10]. He argues that under any interpretation, it would be permitted to change your belief that companies are engaged in wrongdoing in order to avoid the blame of inconsistency[11].

He then proposes an appeal to a more comprehensive conception of 'conscientiousness, or moral seriousness'[12]. This is an argument that a person who does not invest in companies you believe are engaged in wrongdoing is a conscientious (morally serious) person and that a person who invests in those companies is morally frivolous. A conscientious person would not change her belief that companies are engaged in wrongdoing in order to avoid the blame of inconsistency. However, Sandberg points out the conscience of Huckleberry Finn[13]. For Huck, it is against his conscientiousness to assist another man's slave to escape. It is Huck's weakness of will that leads him to do the right thing. Sandberg suggests another type of position:

> "What do these examples show? ... Perhaps we should simply give up on the appeal to conscientiousness, and say that some form of objectively obviously is needed.... We might call this the *objectivist* position. Most philosophers who have discussed issues in connection with ethical investing actually seem to assume this type of position"[14].

In a footnote, Sandberg refers to Irvine[15] and Larmer[16] as holding the 'objectivist' position. I agree with Sandberg that the argument from consistency

[8] Chris J. Cowton and Joakim Sandberg, "Socially Responsible Investment", in *Encyclopedia of Applied Ethics*, (New York: Elsevier, 2012), p. 146.

[9] Joakim Sandberg, "Should I Invest with Conscience", *Business Ethics: European Review,* 16(1): 71-86, 2007.

[10] *Ibid.,* pp. 73-74.

[11] *Ibid.,* pp. 77-78.

[12] *Ibid.,* p. 76.

[13] *Ibid.,* p. 80.

[14] *Ibid.*

[15] William B. Irvine, "The Ethics of Investing", *Journal of Business Ethics*, 6(3): 233-242, 1987.

[16] Robert Larmer, "The Ethics of Investing: A Reply to William Irvine", *Journal of Business Ethics,* 16(4): 397-400, 1997.

fails. It should be noted, however, that conscientiousness is a virtue and frivolousness is a vice. The example of Huckleberry Finn might suggest that we should focus on his other virtues[17]. Let us now turn to the 'objectivist' argument.

3.2. THE EVIL-COMPANY PRINCIPLE[18]

Many people may hold that it is wrong to invest in an 'evil company', as we do here. According to DeGeorge, "[t]he general principle is that if a corporation is established for an immoral end, then no one can morally support its activities through the purchase of its stock"[19]. William B. Irvine calls this the 'evil-company principle'[20]. We can formulate this principle as follows: it is wrong to invest in companies that are engaged in wrongdoing, whether you believe it or not. This seems to be intuitive enough.

Irvine, however, argues against it by giving the following counterexample. We first imagine an evil company, XYZ Company, which uses slave labour to manufacture products that cause horrible deaths. One day, the president of XYZ Company comes to you and announces that he has seen the error of his ways, and promises that if you buy a certain amount of his company's stock, his manufacturing process will no longer require slave labour, and he will stop manufacturing harmful products. In this case, Irvine claims that it is not wrong to buy the stock, and thus rejected the evil-company principle.

Irvine then proposes what he calls the 'enablement principle', according to which, "[i]t is morally wrong for a person to do something that enables others to do wrong"[21]. Thus, even if I do not invest in an evil company, it is morally wrong as long as my investment enables others to do wrong[22].

He seems to assume a consequentialist argument: it is wrong to fail to produce the best consequences; investing in an evil company fails to produce the best consequences; therefore, it is wrong to invest in the evil company. He seems to reject the second premise: investing in an evil company can produce the best consequences. I agree with him on this point. It is an empirical matter, but we can

[17] Nomy Arpaly argues that the example of Huck shows our 'unprincipled virtue'. For more details see Nomy Arpaly, *Unprincipled Virtue: An Inquiry Into Moral Agency* (Oxford: Oxford University Press, 2003). Tommi Juhani Lehtonen emphasizes caring of institutional investors in "Philosophical Issues in Responsible Investment: A Care-ethical Approach", *Social Responsibility Journal*, 9(4): 596-598, 2013.

[18] I examined the evil-company principle elsewhere (Sugimoto [forthcoming]). This discussion is a sequel to that examination.

[19] DeGeorge, *Business* Ethics, p. 271.

[20] Irvine, "The Ethics of Investing", p. 234.

[21] *Ibid*., p. 236.

[22] Irvine does not accept this formulation of the enablement principle, and modifies it (*Ibid.*, 236-241).

easily imagine a shareholder activism which brings about change in an 'evil company'. However, his example is misleading. Robert Larmer points out that if Irvine's example is a counterexample of the evil-company principle, it must be the case not only that XYZ Company was formerly an evil company, but also that it is presently an evil company, which is open to dispute[23].

Even if it produced the best consequences, it might be wrong for other reasons. Cowton and Sandberg make a deontological argument: it is incorrect to profit from the wrongdoing of others; investing in an evil company means profiting from the wrongdoing of others; therefore, it is wrong to invest in that evil company. Irvine seems to reject the first premise. He calls it the 'tainted-profits principle', and argues against it by giving the following counterexample[24]. Suppose that there is a lot of burglary incidents in your neighborhood. You can profit from this wrongdoing. You might go into the guard business, the insurance business or the tool business. However, if you open such a business, you would not do anything wrong.

The second premise is also dubious[25]. It is not necessarily true that investing in an evil company amounts to profiting from its activities. Furthermore, investors profit from their investment when they sell shares. Most of us do not think that selling undesired shares is worse than holding them.

Cowton and Sandberg also present the other deontological argument, what we might call the 'complicity' argument: it is wrong to invest in an evil company because the investors support the company[26]. Cowton and Sandberg argue that to the extent that investors are buying and selling shares on the stock market, the investors are actually not engaging with the underlying companies directly. Even if the investors do not support an evil company financially, they may do it symbolically. Cowton and Sandberg also argue that this is not necessarily so.

There is another possible way to interpret this 'complicity' argument. We can take the case of an investor who invests in an evil company as literally as 'complicity' is understood. Suppose that the ABC Company uses slave labour to manufacture products that cause horrible deaths. The president of ABC Company promises that if you buy a certain amount of his company's stock, he will use more slave labour to manufacture more products. You decide to buy the stock. In this case, you are engaged in wrongdoing. However, again, this is not necessarily so.

Therefore, the argument from an 'evil-company principle' fails.

[23] Larmer, "The Ethics of Investing: A Reply to William Irvine", p. 398. Larmer claims that the enablement principle presupposes the acceptance of the evil-company principle and shows that what is morally desirable is not to do something that enables others to do wrong, but to do something that enables others to do wrong with evil intent. He argues, therefore that the enablement principle requires the evil-company principle (*Ibid.* p. 399-400).

[24] Irvine, "The Ethics of Investing", p. 236.

[25] Cowton and Sandberg, "Socially Responsible Investment", p. 147.

[26] *Ibid.*

4. CONCLUSION

Can responsible investments be justified from an ethical point of view? In this paper, I examined two arguments for responsible investments, and argued that both fail. My conclusion is that the ethical foundation of responsible investments is not firm.

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